COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF VALLEY GAS, INC., FOR APPROVAL OF FINANCING AND RATES	)))	CASE NO. 9689

O R D E R

IT IS ORDERED that:

1. The Staff Report for Valley Gas, Inc., ("Valley") attached hereto as Appendix A shall be included as a part of the record in this proceeding. At the public hearing, the Staff preparing the Staff Report will be available for cross-examination.

2. Valley may have until the close of business, January 21, 1987, to file written comments concerning the contents of Appendix A.

Done at Frankfort, Kentucky, this 16th day of January, 1987.

PUBLIC SERVICE COMMISSION

Richard D. Heman Jr.
Chairman

Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE PUBLIC SERVICE COMMISSION
IN CASE NO. 9689 DATED 1/16/87

COMMONWEALTH OF KENTUCKY

PUBLIC SERVICE COMMISSION

STAFF REPORT

ON

VALLEY GAS, INC.

Prepared By:

Leah Faulkner
Senior Utility Rate Analyst
Gas and Electric Rate Design
Rates & Tariffs Division

and

Tom Wells, Public Utilities
Financial Analyst Principal
Electric and Gas Revenue
Requirements Branch
Rates and Tariffs Division

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STAFF REPORT

ON

VALLEY GAS, INC.

PREFACE

On September 8, 1986, Valley Gas, Inc., ("Valley") filed its application requesting authority to increase its rates charged for natural gas service. The proposed rates would generate approximately $49,423 in additional annual revenues. On November 11-12, 1986, Tom Wells of the Commission's Rates and Tariffs Division audited the expense accounts for the test period.

SCOPE

The scope of the staff work was limited to obtaining information to determine the validity and accuracy of the amounts reported as expenses during the test period. The staff issued an information request on November 26, 1986, to determine the appropriateness of reported revenues, rate base, cost of capital and proposed revenue and expense adjustments.

Audit Summary

Although the account classifications used by Valley to compile its financial statement are not in total agreement with the Uniform System of Accounts for Class C and D Gas Utilities, there were no exceptions found which would materially affect the test-period operating results. Therefore, we have adopted the financial statement as supplied by Valley as the test period for rate-making purposes.

Associated Companies

Valley is supplied rented office space and is supplied labor, management talent, vehicles and insurance coverage from Irvington Gas Company ("Irvington"). Valley is billed semi-annually for these services. Valley is commonly owned with Irvington.

RECOMMENDED ADJUSTMENTS

Cost of Capital

Valley proposed a cost of capital based upon $96,473 of equity funds and $35,000 of long-term debt at respective costs of 15 percent for equity and 12 percent for debt.

Since the Commission has been recently authorizing a 13.75 percent return on equity for large local distribution companies ("LDC"), a small percentage increase for small LDC appears reasonable for the additional risk associated with smaller enterprises. Therefore, the proposed rate of return of 15 percent on equity funds is reasonable. The 12 percent return on debt is the contractual rate evidence by Valley's indenture and appears reasonable.

Valley's equity consisted of $20,000 of uncollected stock subscriptions and $24,960 of paid but undeclared dividends. As the stock subscriptions have not been collected and the stock dividends have been constructively paid, these monies are not available for Valley's use. The staff therefore recommends a reduction of equity funds utilized in calculating the cost of capital of $44,960 to reduce equity funds to $51,513. Using the proposed costs of equity and of debt and using the adjusted book amounts as recommended by staff results in a cost of capital of

13.78 percent as contrasted with the 14.2 percent cost of capital requested by Valley. The staff recommends a 13.78 percent cost of capital for rate-making purposes.

Rate Base

Valley proposed a rate base of $59,786. With the planned construction of approximately $35,000, Valley's proposed rate base was $94,786 of which $6,447 was a cash-working capital allowance. In the absence of a lead-lag study or comprehensive balance sheet analysis of working capital requirements, the Commission usually determines working capital requirements based on a 45-day allowance of operating and maintenance expenses less gas purchases. The staff has recalculated the cash-working capital allowance based on 12.5 percent of operating and maintenance expenses recommended herein and recommends a cash-working capital allowance of $4,689. Therefore, the staff recommends a reduction of $1,758 to the proposed rate base to $93,028 due to the decrease in cash-working capital needs.

Gas Purchases

Valley proposed adjusted gas purchases of $175,268. Staff recommends pro forma annual gas purchases of $177,203 based on Purchased Gas Adjustment Case No. 6902-X and the reported 54,529 Mcfs purchased at an average line loss of 2.5 percent.

Labor, Management Fee, Rent, Vehicle Lease

Valley reported $2,400 in labor, $18,000 in management fees, $2,421 in rent and $2,400 in vehicle leases. Valley proposed adjustments of $1,296 to labor, $4,176 to management fee, $642 to rent and $897 to vehicle leases. All items are supplied by a related company, Irvington, and are not competitively bid nor does Irvington supply these services or rentals to other nonrelated companies. The charges for these services are based primarily on Valley's ability to pay. The adjustments are all based on increases in the Consumer Price Index Urban Workers.

Although the reported test period expenses do not appear excessive the adjustments do not meet known and measurable criteria as they are based on a nationwide urban index which would have little relevance to a privately-owned, cost-based regulated company in rural Irvington. Additionally, as competitive bids were not obtained nor are the services offered in a competitive market it would be very unlikely that each service would increase at exactly the level indicated by an average index for each product. Therefore, the staff recommends the denial of all proposed adjustments to these expenses.

Bad Debts

Valley reported $72 in bad debts expense for the test period. Valley proposed an additional $1,826 in bad debts expense based on 9.336 percent of proposed revenues. Valley's past experience based on 1983, 1984, and 1985 Annual Reports and the test-period financial statements indicate that the average bad debt percentage is approximately .04 percent. Therefore, the staff recommends that the Commission deny Valley's adjustment of $1,826 annual adjustment to bad debts expense. Staff further recommends that the reported level of bad debts expense of $72 be used for rate-making purposes.

Liability Insurance

Valley reported $3,500 in liability insurance for the test period. The liability insurance expense was based on an independent insurance agent's estimation of Valley's share of the total insurance costs of Irvington. Valley proposed a $6,500 annual adjustment to liability insurance expense citing a July 31, 1986, quote of $29,485 from Marsh and McLennan of Louisville. As the amount, $29,485, quoted for insurance coverage does not support the amount, $10,000 sought for rate-making purposes, the staff concludes that the amount quoted is for the total coverage for Irvington. Although the amount, $10,000 annually, sought for rate-making purposes is less than the quoted amount, there was no calculation or independent appraisal of the actual cost to Valley. Therefore, the staff recommends denial of the proposed adjustment of $6,500 annually.

REVENUE AND EXPENSE SUMMARY

The staff recommends adjusting Valley's proposed revenues and expenses as follows:

	Proposed	Adjustment	Adjusted
Operating Revenues & Sales	$203,289	- 0 -	$203,289
Forfeited Discounts	2,302	- 0 -	2,302
Total Operating Revenues	$205,591	- 0 -	$205,591
Operating Expenses & Gas Purchases	175,268	1,935	177,203
Advertising	57	- 0 -	57
Bad Debts	1,898	<1,826>	72
Computer Billing	1,469	- 0 -	1,469
Depreciation Expense	7,675	- 0 -	7,675
Donations	- 0 -	- 0 -	- 0 -
Dues	210	- 0 -	210
Insurance	10,000	<6,500>	3,500

	Proposed	Adjustment	Adjusted
Labor	3,696	<1,296>	2,400
Maintenance	1,535	- 0 -	1,535
Management Fee	22,176	<4,176>	18,000
Miscellaneous Expense	106	- 0 -	106
Postage	878	- 0 -	878
Printing	528	- 0 -	528
Rent	3,063	<642>	2,421
Supplies	223	- 0 -	223
Taxes & Licenses	744	- 0 -	744
Taxes - Sales	- 0 -	- 0 -	- 0 -
Taxes - Utility	- 0 -	- 0 -	- 0 -
Travel	135	- 0 -	135
Vehicle Lease	3,297	<897>	2,400
Legal	2,821	- 0 -	2,821
Total Operating Expenses	$235,779	<13,402>	$ 222,377
Operating Income	$<30,188>	$13,402	$ <16,786>

Revenue Requirements

Valley proposed its revenue requirements based on total proposed operating expenses and its proposed rate of return of 14.2 percent as applied to total capital $131,473 which resulted in a net operating income of approximately $18,670.

Staff is of the opinion that the cost of capital should be determined by weighted average cost of equity and debt funds. However, the cost of capital should be applied to rate base to determine operating income. It is sound ratemaking to determine capital rates from capitalization, however, the rate should be applied to rate base, because rate base is the amount of capitalization used and useful in supplying the service to the utility's customers.

Staff recommends the cost of capital previously determined applied to the rate base to arrive at the required net operating income. The staff recommends the following determination of revenue requirements:

Total Operating Expenses		$222,377
Rate Base	$93,028	
Cost of Capital	13.78%	
Required Operating Income		12,819
Revenue Requirement		$235,196

The staff is of the opinion that Valley is entitled to a revenue increase of approximately $29,605 annually calculated as follows:

Required Revenues	$235,196
Adjusted Revenues	205,289
	$ 29,605

The staff is also of the opinion that the annual increase of approximately $29,605 in Valley's operating revenues will meet all of Valley's substantiated expenses, will provide a fair and reasonable return to its investors, and will provide for reasonable equity growth.

Rate Design

Valley is proposing a $5 customer charge, maintaining that the proposed rate design including a $5 customer charge will produce 50 percent more revenue in the summer months when revenue is needed and that the level of fixed charges divided by the number of bills actually justifies a customer charge of $13.

Valley has provided no support to substantiate this claim. It should be given the opportunity to provide whatever evidence it can during the hearing to support the level of the proposed customer charge.

Respectfully Submitted,

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